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## Rethinking the Oil and Gas Lease

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# TULSA LAW JOURNAL

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## RETHINKING THE OIL AND GAS LEASE

David E. Pierce\*

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The development of oil and gas in America is accomplished through a standard relationship created by documents called oil and gas leases.<sup>1</sup> It has become axiomatic there is no such thing as a standard oil and gas lease *form*, such as a "Producers 88."<sup>2</sup> However, even though the terms

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1. Although the terms of the oil and gas lease create the relationship, they do not necessarily define the limits of each party's rights and obligations under the relationship. *See generally* M. MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES §§ 220-23 (2d ed. 1940); Polston, *Recent Developments in Oil and Gas Law*, 6 E. MIN. L. INST. §§ 19.01-.02 (1985).

2. *E.g.*, *Fagg v. Texas Co.*, 57 S.W.2d 87 (Tex. Comm'n App. 1933). In *Fagg*, the court states: The provision relative to "an 88 form lease" can shed no light on those matters, for the reason that the character of printed matter contained in any designated class of oil and gas lease forms depends on what matter various designers of such forms may deem appropriate—and may vary accordingly.

of the documents are seldom similar, the general structure of the legal relationships they create are typically identical.<sup>3</sup> This suggests that an optimum relationship has evolved and become standardized by repeated use.

The optimum relationship theory is supported by the highly decentralized participation in oil and gas development. There are thousands of individual transactions made throughout the nation by hundreds of companies, individuals, and governmental entities. Regardless of the details of their particular development documents, they all tend to create the "standard relationship."

The goal of this article is to define the standard relationship created by oil and gas leases and then to evaluate whether it is the ideal relationship for developing oil and gas. Although many commentators have examined ways to improve the position of various parties to the standard relationship,<sup>4</sup> the underlying relationship has not been critically analyzed to determine if there might be a better way to structure oil and gas development. Another matter to consider is the effect the standard relationship has on public interests in the oil and gas resource.<sup>5</sup> After evaluating the standard relationship, alternative relationships to develop oil and gas will be explored.

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*Id.* at 89.

3. Although the individual terms of each lease document may vary, the lessor/lessee relationship typically consists of the following four elements: (1) The lessee is given the option to conduct operations on the leased land for a specified period of time, such as three years; (2) If the lessee fails to develop the lease within designated interim periods, such as one year from the lease date, the option will terminate unless the lessee pays a fee to maintain the option; (3) If the lessee's operations are successful, the grant is extended for so long as production is obtained in paying quantities; and (4) The lessee retains all production or proceeds from production after paying or delivering to Lessor a cost-free share of production.

4. Anderson, *David v. Goliath: Negotiating the "Lessor's 88" and Representing Lessors and Surface Owners in Oil and Gas Lease Plays*, 27B ROCKY MTN. MIN. L. INST. 1029 (1982); Cage, *The Modern Oil and Gas Lease—A Facelift for Old 88*, 31 INST. ON OIL & GAS L. & TAX'N 177 (1980); Castleberry, *Protecting the Oil and Gas Lessor*, 30 ROCKY MTN. L. REV. 441 (1958); Hinton, *Negotiating Oil and Gas Leases for the Lessor*, 1 NAT. RESOURCES & ENVT. 7 (1985); Lowe, *Negotiating Oil and Gas Leases for the Lessee*, 1 NAT. RESOURCES & ENVT. 6 (1985); Lowe, *Representing the Landowner in Oil and Gas Leasing Transactions*, 31 OKLA. L. REV. 257 (1978); Merrill, *The Oil and Gas Lease — Major Problems*, 41 NEB. L. REV. 488 (1962); Nickum, *Negotiating and Drafting a Modern Oil and Gas Lease on Behalf of Lessor*, 13 TEX. TECH. L. REV. 1401 (1982); Nordling, *Landowners' Viewpoints in Pipeline Right-of-Way and Oil and Gas Lease Negotiations*, 52 J. KAN. B.A. 35 (1983).

5. Courts and legislatures should not intervene in the resulting relationship to improve the position of a party unless such action promotes, or at least does not adversely affect, public interests in the natural resource. Traditional implied covenant law, as applied to the oil and gas lease, often fails to consider the public interest when determining the lessee's obligations. See generally Pierce, *Coordinated Reservoir Development — An Alternative to the Rule of Capture for the Ownership and Development of Oil and Gas* (pt. 1), 4 J. ENERGY L. & POL'Y 1, 33-49 (1983).

## I. THE STANDARD RELATIONSHIP

The oil and gas lease is designed to give the developer an option, for a stated time, to explore and develop the mineral potential of a tract of land.<sup>6</sup> Generally, the option is acquired with an upfront payment, called a bonus,<sup>7</sup> and maintained during the specified term by annual payments, called delay rental.<sup>8</sup> Bonus and delay rental payments are usually small in relation to the rental value or market value of the land covered by the mineral development option. The landowner's primary compensation for granting the option is the potential for risk-free riches in the form of royalty.<sup>9</sup> The economic aspects of the relationship facilitate the developer's goal of obtaining control over areas of potential mineral value without being under any obligation, during the duration of the option, to conduct development operations.<sup>10</sup> All this is accomplished with a minimal capital outlay because the major compensation to the landowner will be paid out of production from the land, if and when production is obtained.<sup>11</sup>

The four basic oil and gas lease clauses which usually comprise oil and gas leases are the granting clause, habendum clause, drilling/delay rental clause, and royalty clause. The other clauses encountered in lease forms are generally designed to alter in some fashion the four basic

6. See generally E. KUNTZ, J. LOWE, O. ANDERSON, E. SMITH, *OIL AND GAS LAW CASES AND MATERIALS* 108 (1986) [hereinafter *OIL AND GAS LAW*].

7. 8 H. WILLIAMS & C. MEYERS, *OIL AND GAS LAW* 80 (1984) [hereinafter *WILLIAMS & MEYERS*].

8. *Id.* at 206.

9. In *Brewster v. Lanyon Zinc Co.*, 140 F. 801 (8th Cir. 1905), the court, addressing the implied covenant of further development, noted:

The implication necessarily arising from these [oil and gas lease] provisions—the intention which they obviously reflect—is that if . . . oil and gas . . . had been found to exist in the demised premises in paying quantities, the work of exploration, development, and production should proceed with reasonable diligence . . . . That this was of the very essence of the contract is shown by the extensive character of the grant . . . ; by the provisions for the payment of substantial royalties . . . , which, as contrasted with the consideration paid when the lease was executed, shows that the promise of these royalties was the controlling inducement to the grant . . . .

*Id.* at 810.

See M. MERRILL, *supra* note 1, §§ 14, 221.

10. See *OIL AND GAS LAW*, *supra* note 6, at 108.

11. The operator has been desirous of securing a lease with a small capital investment, keeping the lease as long as it was productive or was valuable for speculative purposes, and at the same time, being able to terminate an unprofitable lease without liability to the lessor. The landowner has been interested primarily in obtaining royalties from the lease and therefore has pressed for early exploration and development operations.

3 H. WILLIAMS & C. MEYERS, *OIL AND GAS LAW* § 601, at 2 (1984).

See generally D. PIERCE, *KANSAS OIL AND GAS HANDBOOK* § 9.01 (Kansas Bar Association 1986).

clauses.<sup>12</sup> The granting clause states the substances, land, and associated surface rights which are being transferred to the developer. It also specifies the purpose of the transfer—to explore, develop, and produce the granted substances.<sup>13</sup> The habendum clause states the duration of the granted rights. The grant will terminate after a stated period following the grant unless the developer's efforts result in production of a granted substance, in which case the grant will continue so long as the developer's production income exceeds expenses.<sup>14</sup>

To specify development obligations prior to the discovery of oil or gas, the drilling/delay rental clause was added. This clause imposes an obligation on the developer to drill on the lease during the option period or make periodic payments to the landowner to defer drilling.<sup>15</sup> The royalty clause states the landowner's rights in the event there is production.<sup>16</sup>

The framework for this standard relationship was established shortly after the turn of the century and has remained unchanged since that time.<sup>17</sup> Oil and gas leases creating the standard relationship have been the subject of a considerable amount of litigation.<sup>18</sup> Although specific provisions of the lease documents have evolved to respond to judicial decisions and the perceived needs of the lessee, the relationship has survived unscathed.

## II. WHY HAS THE RELATIONSHIP ENDURED?

The adage "if it works, don't fix it" suggests that we pause before tinkering with a relationship which has been used to develop virtually all of the oil and gas in America. The optimum relationship theory assumes that because the relationship has endured, it has evolved to meet the

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12. For example, the pooling clause is designed to enlarge lessee's rights under all four of the basic lease clauses. Completion, dry hole, cessation, shut-in royalty, and force majeure clauses are designed to enlarge lessee's rights under the habendum clause.

13. See J. LOWE, *OIL AND GAS LAW IN A NUTSHELL* 154-71 (1983).

14. *Id.* at 172-81.

15. *Id.* at 181-208.

16. *Id.* at 258-75.

17. See generally Moses, *The Evolution and Development of the Oil and Gas Lease*, 2 *INST. ON OIL & GAS L. & TAX'N* 1 (1951) [hereinafter Moses].

18. Surveying litigation generated by all other forms of mining lease compared to the oil and gas lease, Professor Merrill observed in 1958:

In the West Publishing Company's Sixth Decennial Digest, fourteen pages are occupied by the paragraphs giving access to cases involving the construction and operation of mining leases dealing with all sorts of minerals except oil and gas. In contrast, the construction and operation of oil and gas leases require seventy-three pages.

M. MERRILL, *THE PUBLIC'S CONCERN WITH THE FUEL MINERALS* 22 (1960).

needs of the parties and society. Legal engineering, like genetic engineering, should concentrate on the cancer and leave properly functioning systems to continue their evolution through natural selection in the legal environment. If the standard relationship created by the oil and gas lease is not the optimal relationship, why has it endured? If we can identify the reasons for its survival, we can determine whether alternatives need to be explored.

Oil and gas leases have evolved in response to the needs of the industry.<sup>19</sup> The developer typically controls the leasing process by presenting the landowner with the developer's "standard" form. As might be expected, this form is designed to maximize the developer's position in the transaction.<sup>20</sup> Depending upon the size of the developer's organization, the form may be presented to the landowner by the developer, through an army of the developer's employees called "landmen,"<sup>21</sup> or through the developer's independent contractors called "lease brokers."<sup>22</sup> Developers may have, at any given time, hundreds or thousands of separate properties under lease. The situation calls for standardization.<sup>23</sup>

Developers have responded by preparing and using standard forms for leasing. The oil and gas lease form offers the developer all the benefits associated with standard forms in other businesses.<sup>24</sup> First, the use of a standard form can give the developer a psychological advantage over the landowner. Suddenly, it appears the only matters open for discussion are those for which a blank is provided.<sup>25</sup> Second, the developer saves time and money by not having to negotiate each transaction and prepare cus-

19. See generally 2 E. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 18.1 (1964).

20. The form is "standard" because the developer attempts to express all leasing transactions, as nearly as possible, using a form document. See M. MERRILL, *supra* note 1, § 221, at 467.

21. The term "landman" refers to "an employee of an oil company whose primary duties are the management of the company's relations with its landowners. Such duties include the securing of oil and gas leases, lease amendments, pooling and unitization agreements and instruments necessary for curing title defects from landowners." WILLIAMS & MEYERS, *supra* note 7, at 450.

22. The lease broker may be hired by the developer to procure leases in an area. When not working as an independent contractor, the lease broker competes for leaseable acreage against other developers and speculators.

23. Once a lease is obtained, its administration is replete with traps for the unwary lessee. Many jurisdictions hold that the drilling/delay rental clause and habendum clause create special limitations on the grant. Failure to comply strictly with lease provisions will often result in automatic termination of the grant. Courts are generally unmoved by a lessee's plea for equity. *E.g.*, *Baldwin v. Blue Stem Oil Co.*, 106 Kan. 848, 189 P. 920 (1920); *Ellison v. Skelly Oil Co.*, 206 Okla. 496, 244 P.2d 832 (1951). Standard form documents aid administration of leases to ensure critical dates and events are not neglected.

24. Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629, 631-32 (1943).

25. Presented with a neatly printed one page form document the landowner is likely to react exactly the way they react to other form documents—how much and where do I sign?

tom-made documents.<sup>26</sup> Third, the developer can send out landmen, instead of managers and attorneys, to obtain the landowner's assent.<sup>27</sup> Fourth, once the form is executed, administration of the lessee's contractual obligations can be standardized.<sup>28</sup> Fifth, in-house policies and judicial interpretations in particular cases can be readily applied to other instances where the form has been used.<sup>29</sup> Sixth, once the form has been proven through use and litigation, the lessee's business risks can be more readily predicted.<sup>30</sup> Finally, standard forms facilitate commerce in oil and gas leases by improving their marketability.<sup>31</sup>

However, when the form turns out to be poorly drafted, unsuited to the situation, or subject to an adverse judicial ruling, the effects can be devastating.<sup>32</sup> The response to adverse rulings has generally been industry-wide, but piecemeal.<sup>33</sup> For example, in 1916 the Oklahoma Supreme

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26. Employees of the developer welcome standard forms because it streamlines their work. They don't have to think about the details of what they are doing. If someone suggests a change in the form they can retort with: "all changes will have to go through our legal department." In the fast-paced world of oil and gas development, the threat of "interminable delay" associated with legal review often preserves the form as written, especially in transactions with other developers who would otherwise be inclined to negotiate changes. Undoubtedly the "letter agreement" was intended to provide similar exemption from legal review—at least until the user realized that the creation of a contract did not depend upon the size of the paper or timeworn formalisms.

27. If each transaction was open for negotiation, persons with authority to negotiate would have to become involved in the leasing process. Standard forms allow the policy makers to establish guidelines for completing form blanks; lower paid nonpolicy makers can then go out and procure signatures.

28. Machine, and now computer, administration of contracts is facilitated by standardized agreements. However, with new developments in computer technology, administering non-standard agreements is now much more simple and safe.

29. If a problem is identified with a clause in a standard agreement, a remedial course of action can be applied to all transactions employing the standard agreement.

30. For example, the developer can look at the royalty clause of its standard form lease and determine whether there are any market value royalty problems. See Kessler, *supra* note 24, at 631-32.

31. This may be the major virtue of the oil and gas lease—everyone uses some sort of lease form which creates the standard relationship. Because trading in leases is a major component of the industry, standard lease forms facilitate their marketability.

32. Suppose the developer uses a standard lease form for operations in Kansas which requires: "Lessee shall pay lessor for gas from each well . . . one-eighth . . . of the gross proceeds at the prevailing market rate, for all gas used off said tract." Assume that in 1960 the developer enters into a long-term contract to sell gas production from leases for \$.20 per thousand cubic feet (MCF). In 1979 the prevailing market price for the same gas is over \$3.00 per MCF and the developer is now receiving, pursuant to the price escalation provisions of the gas contract, \$.60 per MCF. In Kansas, the landowner's royalty will be calculated using the current market value of the gas without being limited by the terms of the gas sales contract or federal price regulation. *Holmes v. Kewanee Oil Co.*, 233 Kan. 544, 664 P.2d 1335 (1983), *cert. denied*, 106 S.Ct. 322 (1985). See D. PIERCE, *supra* note 11, at § 9.50.

33. Developers generally are limited to a prospective response unless they are able to procure lease amendments to deal with the problem. Even when the word is out that a particular form is undesirable, it may take a long time for the minor participants in the industry to learn of the problem. In the interim, the local stationers keep selling the forms they have in stock. Likewise, it may

Court held in *Brown v. Wilson*<sup>34</sup> that the oil and gas lease surrender clause permitted the lessor, under certain circumstances, to terminate the lease after the first delay rental date. A drafting committee composed of attorneys representing various major oil companies prepared a new lease form to address the holding in *Brown v. Wilson*.<sup>35</sup> Their resulting form specifically addressed the *Brown* case, but retained the basic structure of prior oil and gas lease relationships.<sup>36</sup>

Responses to problems with the oil and gas lease since 1916 have been similar—reactionary, addressing problems on a case-by-case basis.<sup>37</sup> “Drafting” leases becomes a process of collecting the adverse decisions since the last redraft and revising the pertinent word, phrase, or clause to respond to the latest episode of judicial hostility toward the document.<sup>38</sup>

Industry-generated oil and gas lease forms have also found their way, through printing companies and stationers, to members of the general public. Depending upon the demand for oil and gas, lands may be leased by individuals and then sold and assigned to others for further speculation or development. When the demand for oil and gas is high, used car salesmen, farmers, real estate agents, insurance salesmen, attor-

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be years before the drafting committee of various associations providing “model” and “approved” forms distribute revisions.

See generally Cage, *The Modern Oil And Gas Lease—A Facelift For Old 88*, 31 INST. ON OIL & GAS L. & TAX’N 177 (1980). Cage notes that in reviewing many printing company lease forms, and a form used by a major oil company, they still used language in 1980 which had proven inadvisable after an adverse ruling in a 1953 Texas Supreme Court case. *Id.* at 203.

34. 58 Okla. 392, 160 P. 94 (1916). *Brown v. Wilson* was subsequently overruled in *Rich v. Doneghey*, 71 Okla. 204, 177 P. 86 (1918).

35. Moses, *supra* note 17, at 29; Walker, *Defects and Ambiguities in Oil and Gas Leases*, 28 TEX. L. REV. 895, 895-96 (1950) [hereinafter cited as Walker].

36. Birth of the present lease form can be traced to *Brown v. Wilson*; this would make the “modern” oil and gas lease 70 years old. See generally Moses, *supra* note 17, at 28-29; Walker, *supra* note 35, at 895-96. However, the standard relationship began taking shape as early as 1895. See Moses, *supra* note 17, at 35-36.

37. The development of completion, dry hole, cessation, shut-in royalty, and force majeure clauses are all examples of the oil and gas bar responding to new interpretations of the lease.

38. See generally Merrill, *supra* note 4, at 491-92 (1961). As one oil and gas scholar has observed:

This form [“Producers 88”] has frequently been revised in the past, and doubtless will be revised many times in the future. Most of the changes that have been made have been directly attributable to defects discovered through litigation and judicial decisions. As the earlier forms were subjected to judicial scrutiny and interpretation, it was found that they were defective in that many problems and situations had not been anticipated by the parties, or if they had, that the clauses used were inadequate or were improperly worded. As these defects were disclosed by judicial decisions, new clauses were added, or old clauses reworded, to eliminate them. This evolutionary process is still going on as is witnessed by the numerous revisions that have been made during recent years.

Walker, *supra* note 35, at 897-98.

The torrent of litigation associated with the oil and gas lease should suggest it is not merely going through an “evolutionary process.”



neys, and anybody else with an entrepreneurial spirit and a good line suddenly enter the leasing market. It is doubtful any of these persons ever develop the leased land. Instead, they sell and assign the leases to developers. To ensure the marketability of leases the car salesman takes, a standard form is used which typically contains the major clauses found in the developers' forms. Printing companies have historically provided the outlet for the car salesman's standard oil and gas lease form.<sup>39</sup>

The oil and gas lease form has all the aura of other neatly printed documents—the negotiation process typically consists of filling in the blanks.<sup>40</sup> The opportunity to experiment with alternative relationships is foreclosed because negotiation concerning the general structure of the relationship never takes place. Landowners, especially in areas which have not experienced extensive development, tend to accept the form terms without debate.<sup>41</sup> Courts recognize this phenomenon of human nature and have developed interpretive rules to try and balance each party's position in the relationship.<sup>42</sup> Courts generally view the oil and

39. It was a printer, not an attorney, who dubbed the oil and gas lease with the title "Producer's 88." Moses, *supra* note 17, at 29-32; Walker, *supra* note 35, at 896.

40. RESTATEMENT (SECOND) OF CONTRACTS § 211 comment b, (1981) states:

A party who makes regular use of a standardized form of agreement does not ordinarily expect his customers to understand or even to read the standard terms. One of the purposes of standardization is to eliminate bargaining over details of individual transactions, and that purpose would not be served if a substantial number of customers retained counsel and reviewed the standard terms. Employees regularly using a form often have only a limited understanding of its terms and limited authority to vary them. Customers do not in fact ordinarily understand or even read the standard terms. They trust to the good faith of the party using the form and to the tacit representation that like terms are being accepted regularly by others similarly situated. But they understand that they are assenting to the terms not read or not understood, subject to such limitations as the law may impose.

"The customer assents to a few terms, typically inserted in blanks on the printed form, and gives blanket assent to the type of transaction embodied in the standard form." *Id.* comment c, at 120.

41. The leasing process in some cases may be initiated and consummated on the hood of an idling tractor.

Professor Merrill describes the typical oil and gas leasing process as follows:

[M]ay not the lessor protect himself by the insertion of general covenants for exploration, development, operation and protection, similar to those which the courts imply? . . . [T]he leases are not drawn by the lessor, nor *de novo* for each transaction. They are taken upon standard forms, prepared by the lessees or with a view to their special interests. If special terms are to be inserted, they must be demanded by the lessor. But the ordinary lessor, not versed in the peculiarities of oil and gas, nor yet in the rules of law which govern the liabilities of lessees, may not know what clauses are necessary for his protection, nor how to draw them if he knew of their necessity.

M. MERRILL, *supra* note 1, § 221, at 467.

42. Professor Sullivan notes in his handbook:

[C]ourts proceeded to construe such instruments in the light of the subject matter and the situation of the parties. This led to the formulation of three rules that are responsible in great measure for the existence of a separate jurisprudence on the law of oil and gas, namely,

1. The lease is to be construed most strongly against the lessee and in favor of the lessor;
2. It will be construed to promote development and prevent delay; and

gas lease as a contract drafted by the lessee for the lessee. Often, the resulting relationship is perceived as being too one-sided in the lessee's favor. Although not procured by fraud or misrepresentation, and not so unfair as to be unconscionable, the rights created by the oil and gas lease have been subjected to close judicial scrutiny.<sup>43</sup>

A major reason for endurance of the relationship is the willingness of courts to take what they perceive to be an unfair contract and make it fair through creative interpretation. This "unfairness" arises out of a combination of perceived substantive and procedural unconscionabilities visited upon the lessor.<sup>44</sup> The familiar targets of judicial scrutiny focus upon the consideration paid for the lease and the lessor's expectation of

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3. Forfeitures will be favored where there is an express provision therefor in the lease. R. SULLIVAN, HANDBOOK OF OIL AND GAS LAW § 32, at 82-83 (1955).

43. In *Rook v. James E. Russell Petroleum, Inc.*, 235 Kan. 6, 679 P.2d 158 (1984), the Kansas Supreme Court notes:

Oil and gas leases containing ambiguities are to be strictly construed against the lessee-producer and in favor of the lessor-royalty owner because the lessee usually provides the lease form or dictates the terms thereof, and where the lessee desires it may protect itself by the manner in which the lease is drawn.

*Id.* at 14, 679 P.2d at 164. See generally SULLIVAN, *supra* note 42, § 32, at 84-85.

44. RESTATEMENT (SECOND) OF CONTRACTS § 211 (1981), which addresses standardized agreements, recognizes the person drafting a standard form may be inclined to "overdraw" the document to maximize their client's position. Section 211(3) provides: "Where the other party has reason to believe that the party manifesting such assent would not do so if he knew that the writing contained a particular term, the term is not part of the agreement." This rule is further defined in comment f which states:

Although customers typically adhere to standardized agreements and are bound by them without even appearing to know the standard terms in detail, they are not bound to unknown terms which are beyond the range of reasonable expectation. . . . Similarly, a party who adheres to the other party's standard terms does not assent to a term if the other party has reason to believe that the adhering party would not have accepted the agreement if he had known that the agreement contained the particular term. Such a belief or assumption may be shown by the prior negotiations or inferred from the circumstances. Reason to believe may be inferred from the fact that the term is bizarre or oppressive, from the fact that it eviscerates the non-standard terms explicitly agreed to, or from the fact that it eliminates the dominant purpose of the transaction. The inference is reinforced if the adhering party never had an opportunity to read the term, or if it is illegible or otherwise hidden from view. This rule is closely related to the policy against unconscionable terms and the rule of interpretation against the draftsman.

*Id.* at comment f.

Although courts have not directly articulated this analysis as a basis for their hostility toward the oil and gas lease, it seems to fit nicely with many of the "rules" courts have formulated through lease interpretation. For example, the scope of the phrase "other minerals" has been limited to substances that would not surprise the lessor when their lessee attempts to surface mine for minerals under an "oil and gas" lease. *Cf.*, e.g., *Christensen v. Chromalloy Am. Corp.*, 99 Nev. 34, 656 P.2d 844 (1983) (deed excepting "coal, oil, gas and other minerals" not clear whether parties intended to include barite which requires open-pit mining); *Moser v. United States Steel Corp.*, 676 S.W.2d 99 (Tex. 1984) (deed excepting "oil, gas and other minerals" includes uranium but mineral estate owner must pay for any surface destruction necessary to extract "other minerals"); *Acker v. Guinn*, 464 S.W.2d 348 (Tex. 1971) (deed conveying "oil, gas, and other minerals" did not include iron ore surface minerals which would require destruction of the surface estate), *modified*, *Moser*, 676 S.W.2d at 99.

development to generate royalty.<sup>45</sup> Because the lease gives the lessee the exclusive right to develop the property, without any express obligation to develop, courts imply varying obligations on the lessee to ensure diligent development.<sup>46</sup> A court willing to police the bargain head-on might find such a contractual arrangement substantively unconscionable.<sup>47</sup> Similarly, the court might find procedural unconscionability in the cryptic code the oil and gas lease form employs to express the respective rights of the parties.<sup>48</sup> Although the print is legible, and the lessor is given an opportunity to read it, most lessors, and attorneys unfamiliar with the "code," will not appreciate its scope and effect.<sup>49</sup>

But courts have not directly attacked the conscionability of the oil and gas lease. Most litigants, instead of attacking the fairness of the relationship, have sought relief through benevolent judicial construction of the lease.<sup>50</sup> This approach has given rise to the familiar rules of con-

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45. See, e.g., *Sauder v. Mid-Continent Petroleum Corp.*, 292 U.S. 272 (1934).

46. M. MERRILL, *supra* note 1, at § 221.

47. If the lease, as written, gives the lessee too good a bargain, at the expense of the lessor, it may rise to the level of being "substantively" unconscionable. Cf. *Shell Oil Co. v. Marinello*, 63 N.J. 402, 307 A.2d 598 (1973), *cert. denied*, 415 U.S. 920 (1974) (termination provision in gas station lease). See also *Tannock v. N.J. Bell Telephone Co.*, 212 N.J. Super. 506, 515 A.2d 814 (1986).

48. If the manner in which the agreement is presented tends to impede the ability of the landowner to make an informed choice, "procedural" unconscionability may be present. See *Weaver v. American Oil Co.*, 257 Ind. 458, 276 N.E.2d 144 (1971) (uneducated gas station operator could not appreciate the scope and effect of gas station lease provisions).

Professor Merrill alludes in his treatise to what many courts may find "procedurally" unconscionable: "The lease is full of provisions which speak of the payment of royalties, of the drilling and operation of wells, and, to the ear of the ordinary layman, may well seem to promise immediate and efficient development without need of further words." M. MERRILL, *supra* note 1, § 221, at 467.

49. See generally RESTATEMENT (SECOND) OF CONTRACTS § 208, comment a (1981). Section 208 incorporates, as a general policy of contract law, the unconscionability concepts found in U.C.C. § 2-302 (1978 version). This would appear to be an invitation to courts to police the fairness of agreements by direct, as opposed to indirect, means. Comment a to Section 208 provides: "Particularly in the case of standardized agreements, the rule of this Section permits the court to pass directly on the unconscionability of the contract or clause rather than to avoid unconscionable results by interpretation." The intended scope of the court's policing function is suggested by comment c: "Theoretically it is possible for a contract to be oppressive taken as a whole, even though there is no weakness in the bargaining process and no single term which is in itself unconscionable."

50. Courts have not been willing to directly evaluate the conscionability of the oil and gas lease. Where the issue has been litigated, the oil and gas lease has been upheld where there was no evidence of fraud or misrepresentation. Compare *Ringle v. Quigg*, 74 Kan. 581, 87 P. 724 (1906) (lease with 20 year primary term not unconscionable) with *Sledd v. Munsell*, 149 Kan. 110, 86 P.2d 567 (1939) (consideration inadequate to support defeasible term mineral conveyance where grantor was disabled and grantee represented document as an oil and gas lease) and *Serena v. Rubin*, 146 Kan. 603, 72 P.2d 995 (1937) (facts similar to *Sledd*).

This approach is consistent with judicial reaction to unconscionability in other contractual settings. Professor Farnsworth has observed: "On the whole, judges have been cautious in applying the doctrine of unconscionability, recognizing that the parties often must make their contract quickly, that their bargaining power will rarely be equal, and that courts are ill-equipped to deal with problems of unequal distribution of wealth in society." E. FARNSWORTH, CONTRACTS § 4.28, at 316 (1982). Courts have probably also been reluctant because of the difficulty in drawing the line

struction that the lease will be interpreted against the lessee, and in favor of the lessor, and to promote development and prevent delay.<sup>51</sup> Although courts purport to be searching for the parties' intent, the express terms of the lease, drafted by the lessee with little or no input from the lessor, contain little that would allow the court to mitigate the resulting hard bargain. The result is that the court concludes their "interpreted" version of the contract must be what was "intended" because what the parties agreed to was unfair. Cryptic lease clauses facilitate this "interpretive" process.<sup>52</sup> Dealing with the perceived inequities of the bargain in this manner tends to preserve and perpetuate a relationship that would have otherwise fallen into disuse because courts would not enforce it as written.

After thousands of cases recognizing the validity of the modified relationship, it is doubtful courts will now embark upon a direct attack against the lease. After thousands of cases validating and defining the scope of the relationship, it is doubtful practitioners will venture too far beyond its established confines. As Professor Merrill has observed:

Because of the empiric manner in which it has developed, the typical oil and gas lease has little to recommend it, either as a literary composition or as an example of master draftsmanship. It is too long, over-wordy, and poorly organized. It is full of inconsistencies and contradictions, thereby multiplying the opportunities for judicial construction or misconstruction. Yet, because so many decisions have given it effect in one way or another, no one bent on reform dares to abandon the past and concoct a simpler, shorter, more logical document. Instead, words are altered. New phrases, clauses, sentences or sections are added. The crazy old structure remains, like a house which has been built onto, time and again.<sup>53</sup>

However, efforts to define the relationship show no sign of receding. Af-

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between conscionable and unconscionable conduct. Unconscionability analysis often seems to parallel the "obscene" — judges "know it when they see it."

51. R. SULLIVAN, *supra* note 42, § 32, at 84-85.

52. For example, in *Ohio Oil Co. v. Detamore*, 165 Ind. 243, 73 N.E. 906 (1905), the court, in apparent exasperation, stated:

Whether it proceeds from design of crafty speculators in oil and gas leases to enshroud their contracts with doubtful, ambiguous, inconsistent, and absurd provisions, as a means of promoting their interests, or whether it comes from a custom in the rural districts of employing unskilled draftsmen, it is a notable fact that few subjects of contract contribute to the courts an equal proportion of written agreements for interpretation. The fact is so patent that courts generally, in gas and oil states, have come to place such contracts in a class of their own, and to look critically into such instruments for the real intention of the parties, because it so frequently happens that they cannot, on account of incongruous provisions, be enforced according to the strict letter of the contract.

*Id.* at 248, 73 N.E. at 908. See also, *Federal Betterment Co. v. Blaes*, 75 Kan. 69, 74, 88 P. 555, 556-57 (1907).

53. Merrill, *supra* note 4, at 491-92.

ter almost a century of litigation, the lease and the relationship it creates continue to evoke novel and difficult interpretive issues which only the court's can marshal. An inordinate amount of litigation continues in an effort to define and police the relationship.<sup>54</sup> Perhaps it is time for reform; time to dare to "concoct" not only new contractual expressions of the lease relationship, but to explore alternatives to the relationship. Clinging to the established relationship because it has been the subject of extensive litigation is like keeping an inherently defective automobile because you have invested extensive sums of money on repairs.<sup>55</sup>

Once a lease form is selected, it may continue as a viable document for years. If production is obtained during the primary lease term, the lease will remain in effect until it is no longer profitable to produce from the lease.<sup>56</sup> Initial production, supplemented by further discoveries, could extend the lease for decades. Once the lease increases in value, whether actual or speculative, it becomes difficult to amend. Therefore, development typically takes place pursuant to the original lease terms. The lease has an assured endurance, the relationship it creates becomes the norm.

The persistence of the oil and gas lease can also be attributed to the "form mentality" which permeates all disciplines of the law. The drafting process too often begins and ends with selection of a form. The form invariably becomes the mold into which the agreement is poured. This is not to say the drafting attorney must "reinvent the wheel" each time a transaction is proposed. The problem is that many attorneys have never invented the wheel. Instead, they continue the process of using forms without independent analysis of why certain language is used or why a particular relationship is being created to effect the transaction.<sup>57</sup> Forms tend to be self-perpetuating; once they are used the justification for their

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54. Employing an analysis similar to that used by Professor Merrill in his book, *THE PUBLIC'S CONCERN WITH THE FUEL MINERALS*, *supra* note 18, in the West Publishing Company's SEVENTH, EIGHTH, and NINTH DECENNIAL DIGESTS, there is a total of 27 pages of case references concerning the interpretation of non-oil and gas mining leases. Contrast this with 148 pages of case entries on oil and gas lease interpretation.

55. The oil and gas lease is an "adjudicated form." Beardsley, *Beware of, Eschew and Avoid Pompous Prolivity and Platitudinous Epistles!*, 16 CAL. ST. B.J. 65 (1941). Beardsley defines the adjudicated form as one "that has attached to it a certificate that there is something terribly wrong with it. If there was not something terribly wrong with it, it never would have been adjudicated." *Id.* at 66.

56. *E.g.*, Clifton v. Koontz, 160 Tex. 82, 325 S.W.2d 684 (1959).

57. D. PIERCE, *supra* note 11, at §§ 5.13 -16. See generally R. DICKERSON, *THE FUNDAMENTALS OF LEGAL DRAFTING* § 4.11 (2d ed. 1986).

continued use is often "that's the form we've always used—and everyone else uses."

If it works well, don't fix it. But the history of the oil and gas lease suggests it may not be working so well. Certainly, the oil and gas lease has "worked" in the sense that it has permitted the industry to develop the oil and gas resource in America. But could other relationships have facilitated development equally as well without the need for extensive judicial intervention? What "price" has the industry, landowners, and society paid to operate under the standard relationship? The oil and gas lease, and the standard relationship it creates, appear to have endured because of the early selection of a general lease format which the courts were willing to accept and modify as necessary to create the minimum "fair deal" for the lessor. Lessees, apparently satisfied with their position under the "interpreted" lease, left the basic format of the relationship untouched. Instead, they responded to adverse judicial interpretations narrowly—revising only the portions of the lease necessary to respond to the court's latest lesson while being careful to maintain the basic lease structure.<sup>58</sup>

The endurance of the relationship has been further aided by the need for standardization and the existence of major participants in the industry which establish the norm for such standardization through their own lease forms. Minor participants, to ensure marketability of their leases to the major participants, naturally embrace a lease form acceptable to their potential assignees. Printing companies, stationers, and various associations serve as the middlemen for communicating the form requirements of the major participants to the minor participants.<sup>59</sup> Couple this with the potentially long-term duration of leases and a practicing bar generally enamored with forms, and the standard relationship appears indestructible. But is it the optimum relationship?

### III. CONFLICTS INHERENT TO THE RELATIONSHIP

Problems associated with the oil and gas lease are not merely "drafting" problems. Although most lease forms are poorly drafted, and much litigation could be avoided through better drafting,<sup>60</sup> drafting a better

58. See generally Moses, *supra* note 17.

59. Perhaps the largest distributor of oil and gas lease forms is the American Association of Petroleum Landmen (AAPL). AAPL "approved" lease forms are marketed through Kraftbilt Products, a printing and publishing company.

60. The typical oil and gas lease form leaves too much for factual resolution; matters which often could be easily addressed in the lease. For example, how simple it would be to define the scope

lease will not address weaknesses inherent to the relationship. Many of the shortcomings of the lease document could be avoided if the relationship it created was not so patently disharmonious.

#### A. *Conflict Between Lessor and Lessee*

Throughout the duration of an oil and gas lease, the interests of the parties to the standard relationship seldom coincide.<sup>61</sup> A major component of the relationship is the lessee's right to develop, without any obligation to develop.<sup>62</sup> The lessee's option conflicts with the other major component of the relationship: the lessor's expectation that development will be diligently pursued to generate royalty.<sup>63</sup> The lessor's greatest potential for economic gain from the leasing transaction is the receipt of royalty.<sup>64</sup> However, before there can be royalty, there must be production. Before there can be production, there must be exploration and development. The relationship is further strained because the lessee must pay for development; the lessor's royalty is calculated as a "cost-free" share of production.<sup>65</sup>

Where the parties expressly address development obligations, the expectations of each party are defined and the opportunity for dispute is reduced; assuming the lessor, when entering into the lease, appreciated the scope and effect of the "express" lease terms.<sup>66</sup> For example, the drilling/delay rental clause specifies the lessee's development obligations during the primary term of the lease. There is also a specified considera-

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of the term "commence," expenses to be considered in determining "paying quantities," and the costs subsequent to production which can be charged against the lessor's royalty.

61. M. MERRILL, *supra* note 1, § 1, at 15.

62. OIL AND GAS LAW, *supra* note 6, at 108.

63. *Brewster v. Lanyon Zinc Co.*, 140 F. 801 (8th Cir. 1905).

64. M. MERRILL, *supra* note 1, § 14 at 49.

65. As Professor Kuntz notes in his treatise:

To a limited extent, the interests, of the lessor and lessee concur in the exploration, development, and operation of the premises covered by the oil and gas lease. Their interests concur in that they both derive economic benefit from the production of oil and gas. To a greater extent, however, their interests are in conflict.

The cause of the conflict in the interests of the lessor and lessee is very simple. The lessee must bear the cost of any operation on the leased premises, whether such operation is in exploration, development, or production; while the lessor derives his benefit from production, free and clear of all costs. It is true that any activity in the exploration, development, and operation of the leased premises involves a risk of loss to both lessor and lessee, but the risk of loss to which the lessor is exposed is negligible in comparison to the risk undertaken by the lessee.

5 E. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 54.2, at 1-2 (1978). *See also*, OIL AND GAS LAW, *supra* note 6, at 278, n. 1.

66. Courts have even been hostile towards express terms; probably because they are presented for the landowner's assent as part of a standard form which the landowner seldom reads and, when they do read it, rarely understands. *See* M. MERRILL, *supra* note 1, § 221, at 464.

tion to be paid in the event of delayed development during the primary lease term. Such a clause, if read, should put the lessor on notice that his expectation of royalty may be delayed. Lessors probably consider delay under these circumstances "fair" because they are paid a rental for the delay and the option to pay delay rental runs only until the end of the fixed primary term.<sup>67</sup> However, perhaps realizing lessors seldom read or understand the leases they sign, many courts construe the lessee's option to delay development strictly.<sup>68</sup> For example, if the lessee is a day late or a dollar short in making delay rental payments, the lease will terminate and equity will not intervene to prevent a situation which under other relationships would be considered a forfeiture.<sup>69</sup>

Most conflicts arise after the discovery of oil or gas. Following discovery, the extent and rate of development must be determined. The lessor will favor, and often demand, immediate and complete development of the leased land. This is because one more unit of produced oil or gas will provide lessor with one more unit of profit under the lease. Conversely, lessee's profit is not incremental because he must subtract from each unit of oil or gas the full costs of development and operation plus the lessor's cost-free share of production. The lessee will further develop the lease only when the present value of lessee's share of the projected additional production from the land will exceed the costs of developing and operating the lease.<sup>70</sup>

67. See generally 3 E. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 27.1, at 1 (1967).

68. See generally R. HEMINGWAY, THE LAW OF OIL AND GAS § 6.3, at 223 (2d ed. 1983).

69. Most states hold failure to meet the literal terms of the "unless" form of drilling/delay rental clause will result in the automatic termination of the lease. The express lease terms create a "special limitation" on the grant. Once stated events occur, or fail to occur, the grant terminates automatically. The equities of the situation are not in issue. OIL AND GAS LAW, *supra* note 6, at 139, n.2. See also D. PIERCE, *supra* note 11, § 9.30.

70. Professor Merrill notes in his treatise:

The conflict of the interests asserted by lessor and lessee is especially marked in respect to the time and manner of exploring the leased premises for oil and gas and to the extent to which they shall be developed and operated in the event that exploration results in the discovery of either oil or gas in paying quantities. Here the interests of the lessor and the lessee may be distinctly opposed to each other. Since his returns from the lease are to be derived chiefly from the royalty to be paid upon production of oil or gas, the lessor is generally anxious that the work of exploration shall be commenced at the earliest possible date. The lessee, on the contrary, if the property is not in a proven field, may desire to hold it undeveloped, either for the purpose of speculation or as a reserve for future exploitation. Again, if exploration results in the discovery of oil or gas, the lessor often desires that the maximum production be developed in order that he may receive immediate returns in the form of royalties. The lessee may conceive that a better return upon the investment will be secured by delaying intensive development until the advent of higher prices for the product, or that the production of the well or wells already drilled is so small as to indicate that the sinking of additional wells would be unprofitable although the lessor's royalty might be increased.

M. MERRILL, *supra* note 1, § 1, at 17-18 (footnotes omitted).



Leases seldom address development obligations after production is obtained.<sup>71</sup> Therefore, courts have rallied to specify development obligations to balance the lessor's expectation of royalty with the lessee's desire to maximize the return on the existing investment and avoid unprofitable development.<sup>72</sup> The guide is what a "prudent operator" would do under the circumstances, considering the lessor's interests as well as the interests of the lessee.<sup>73</sup> The major problem with the prudent operator standard is it often requires a lawsuit to distinguish prudent self-interest from imprudent selfishness.<sup>74</sup> If the economic interests of the parties tended to coincide on the issue of further development, each party's economic self-interest, instead of a court, would determine future development issues.

Although not expressly addressed in the oil and gas lease, courts require lessees to produce and market oil and gas following its discovery.<sup>75</sup> Because the lessor's primary concern is receipt of royalty, discoveries must be promptly produced and marketed. When the price of oil drops, and the lease is not subject to drainage, the lessee may want to

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71. *Id.* § 2, at 19.

72. *E.g.*, *Rush v. King Oil Co.*, 220 Kan. 616, 619, 556 P.2d 431, 435 (1976).

73. The prudent operator standard, as applied in most states, was fashioned by Judge Van Devanter, later Justice Van Devanter of the United States Supreme Court, in an opinion for the Court of Appeals for the Eighth Circuit reviewing a decision of a Kansas federal district court. In *Brewster v. Lanyon Zinc Co.*, 140 F. 801 (8th Cir. 1905), Judge Van Devanter articulates the prudent operator standard:

The object of the operations being to obtain a benefit or profit for both lessor and lessee, it seems obvious, in the absence of some stipulation to that effect, that neither is made the arbiter of the extent to which or the diligence with which the operations shall proceed, and that both are bound by the standard of what is reasonable. This is the rule in respect of all other contracts where the time, mode, or quality of performance is not specified, and no reason is perceived why it should not be equally applicable to oil and gas leases. There can, therefore, be a breach of the covenant for the exercise of reasonable diligence, though the lessee be not guilty of fraud or bad faith.

But, while this is so, no breach can occur save where the absence of such diligence is both certain and substantial in view of the actual circumstances at the time, as distinguished from mere expectations on the part of the lessor and conjecture on the part of mining enthusiasts. The large expense incident to the work of exploration and development, and the fact that the lessee must bear the loss if the operations are not successful, require that he proceed with due regard to his own interests, as well as those of the lessor. No obligation rests on him to carry the operations beyond the point where they will be profitable to him, even if some benefit to the lessor will result from them. It is only to the end that the oil and gas shall be extracted with benefit or profit to both that reasonable diligence is required. Whether or not in any particular instance such diligence is exercised depends upon a variety of circumstances . . . . Whatever, in the circumstances, would be reasonably expected of operators of ordinary prudence, having regard to the interests of both lessor and lessee, is what is required.

*Id.* at 814.

74. "Prudent operation" is a fact-sensitive issue. Courts must intervene. Enough litigation has been generated over the years to warrant a separate treatise on the subject: Maurice H. Merrill's *COVENANTS IMPLIED IN OIL AND GAS LEASES* was first published in 1926 with a second edition in 1940 and an extensive supplement in 1964.

75. M. MERRILL, *supra* note 1, at §§ 72, 84, at 182, 212.

cease production from the lease to await better prices. Similarly, if the well is capable of producing gas, the lessee may want to withhold it from the market to await higher prices.<sup>76</sup> Such action, without the lessor's consent, would violate the implied covenant to produce and market oil and gas from the lease.<sup>77</sup>

Arguably, if the economic interests of the lessor and lessee were more congruent, the lessor would, by prior or subsequent agreement, permit the lessee more latitude in determining when to produce and market. This greater latitude could ultimately lead to greater "stability" in oil and gas prices, higher income for the lessor and lessee, and increased total production from the reservoir.<sup>78</sup>

However, before lessees can improve their position under any sort of new relationship, they must overcome a major "attitude problem." The problem is that lessees look upon lessors as somebody you talk to the day you take the lease and maybe on the day you enter their property to drill the well. Afterwards, the lessee's only contact with the lessor will be a noncommunicative delay rental or royalty check.<sup>79</sup> Other contacts are initiated only when the lessee wants something more from the lessor, or the lessor is upset about something and contacts the lessee. Courts have, indirectly and seldom with comment, alluded to this attitude problem in a few cases.<sup>80</sup> Lessees refuse to treat the lessor as a participant in the development enterprise. This reluctance probably stems from the nature of the lessor's investment in the enterprise. The lessor has given the

76. A price increase in a free market would indicate an increase in demand. This should prompt the gas purchaser to seek new reserves to meet anticipated increases in demand. Because long-term contracts are commonly used to secure gas reserves, it would be in the producer's best interest to market gas when prices, and demand, are high. Generally, producers will be in a better position to demand favorable contract terms when prices are high.

77. *Howerton v. Kansas Natural Gas Co.*, 81 Kan. 553, 106 P. 47 (1910), *rev'd in part*, 82 Kan. 367, 108 P. 813 (1910) (reversed as to remedy for breach of marketing covenant; damages adequate).

78. The parties will still have to contend with the rule of capture.

79. Some states now require the royalty check to be more "communicative" so the lessor can conduct a crude audit of royalty calculations. *E.g.*, N.D. CENT. CODE § 38-08-06.3 (Supp. 1985) and N.D. ADMIN. CODE § 43-02-06 (1985); OKLA. STAT. ANN. tit. 52, §§ 567-68 (West 1986).

80. In *Schupbach v. Continental Oil Co.*, 193 Kan. 401, 394 P.2d 1 (1964), the lease provided that the lessee would pay the lessor a gas royalty calculated as "1/8th of the proceeds of the sale thereof at the mouth of the well." *Id.* at 402, 394 P.2d at 2. To market the gas, the lessee built compression systems to pressurize the gas stream for delivery into the purchaser's pipeline. The lessee charged a 1/8th share of its claimed compression costs against its lessor. Denying any deduction for compression costs, the Kansas Supreme Court noted:

Continental . . . constructed its compressor station . . . and commenced compressing the gas . . . without consulting the lessors and royalty owners as to the location of the compressor station or as to the size or number of stations or as to any intention on its part to charge compression costs to the royalty owners . . . . In addition, Continental has made a substantial net profit from its gas compression operations . . . .

*Id.* at 406, 394 P.2d at 5.

lessee the right to develop the property in return for an upfront cash payment and periodic cash payments. Any development will be risk-free to the lessor, and because they have already been paid for the lease, lessees may ask: why should they be involved in our business?

Typically, lessees make decisions which directly impact the lessor's interests without any input from the lessor.<sup>81</sup> In most cases, their decisions are based upon the cryptic code of the oil and gas lease. Although lessees view the lessor as just another creditor, courts have intimated the relationship requires more.<sup>82</sup> When the lessee makes economic decisions which impact the lessor, without the lessor's informed consent, the lessee often becomes an "insurer" of the lessor's interests. For example, in many states when the lessee contracts with a gas purchaser to sell gas, without the lessor's consent, the lessee in effect becomes an insurer that the lessor will receive a royalty based upon the current market value of the gas.<sup>83</sup> This is the result even though the lessee may have, in good faith, entered into a long-term gas sales agreement fixing the price for gas at something less than market value.<sup>84</sup>

Lessees may assert "market value," as used in the lease, is actually a shorthand statement to indicate that the lessee is entitled to charge a proportional share of gathering, transportation, treatment, and compres-

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81. This may occur, for example, when lessees commit gas to a long-term gas sales agreement. Consider the following statement of the problem:

Perhaps the greatest problem for lessees under the royalty clause, and the oil and gas lease in general, is determining when it is necessary, or advisable, to include the lessor in the lease operation decision-making process. For example, most market value royalty problems could be avoided if the lessor, at the time a gas contract was being entered into, joined in the gas sales contract. If the lessor is consulted when the gas purchase contract is offered, they may commit to the contract and be willing to sign the necessary lease amendment so royalties can be calculated according to the contract proceeds.

D. PIERCE, *supra* note 11, § 11.21.

82. Unless the terms of the lease provide otherwise, the typical oil and gas lease does not create a fiduciary relationship between lessor and lessee. The parties have the duty to act "honestly and fairly" toward one another. *Waechter v. Amoco Production Co.*, 217 Kan. 489, 510, 537 P.2d 228, 248 (1975), *followed*, 219 Kan. 41, 546 P.2d 1320 (1976).

One way courts could extend their paternalistic role in this area is to characterize the lessor/lessee relationship as fiduciary. *Cf. Manges v. Guerra*, 673 S.W.2d 180 (Tex. 1984) (obligation of executive rights owner to protect the interests of nonexecutive); *Probst v. Hughes*, 143 Okla. 11, 286 P. 875 (1930) (operating interest owner owed fiduciary duty to nonoperating interest).

83. See generally *Piney Woods Country Life School v. Shell Oil Co.*, 726 F.2d 225 (5th Cir. 1984), *cert. denied*, 471 U.S. 1005 (1985). *Contra*, *Hillard v. Stephens*, 276 Ark. 545, 637 S.W.2d 581 (1982); *Henry v. Ballard & Cordell Corp.*, 418 So.2d 1334 (La. 1982); *Tara Petroleum Corp. v. Hughey*, 630 P.2d 1269 (Okla. 1981).

84. *E.g.*, *Holmes v. Kewanee Oil Co.*, 233 Kan. 544, 664 P.2d 1335 (1983), *cert. denied*, 106 S.Ct. 322 (1985). In *Holmes* the court held that a gas royalty clause providing for payment to lessor of "one-eighth (1/8) of the gross proceeds at the prevailing market rate" required payment on the "value or price at the current rate prevailing when the gas [was] delivered rather than the proceeds or amount realized under a gas purchase contract." *Id.* at 548, 664 P.2d at 1339.

sion costs against lessor's "cost-free" royalty.<sup>85</sup> However, courts in most states have not been willing to decode such terms in the fashion lessees desire. Instead, new meaning is attributed to the term through interpretation, and the lessees find that they must not only pay royalty based upon current market values, they are also unable to charge any of the proportional costs of gathering, transportation, treatment, and compression against lessor's share.<sup>86</sup>

Three factors combine to make the oil and gas lease a volatile document for lessees:

1. The lease uses many imprecise terms which can easily be interpreted to mean something the lessee never intended.
2. Courts are generally hostile towards the lessee when such terms become the subject of litigation. Although the official statement of this hostility is the "construe ambiguous terms against the drafter rule," many cases seem to predicate their holdings upon a perception that the contract, as written, is inherently unfair.
3. The economic interests of the lessor and lessee often conflict. This creates friction between the parties and often leads to litigation where the outcome will be determined after interpreting the imprecise terms. When the matter has not been previously addressed, the court will extrapolate, from the terms of the lease and the relative positions of the parties, what it thinks would be a fair resolution of the dispute under the circumstances.

The effect of these factors can be summarized in the maxim: "When in doubt, the lessee always loses." Perhaps the most interesting observation is that the damage is self-inflicted. The lessee selects the relationship and the document expressing the relationship, and controls the negotiation process through standardized forms. After almost a century of experience, it is odd that lessees still use the same relationship and, to a great extent, the same form documents to create the relationship.

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85. See Lowe, *Developments in Nonregulatory Oil & Gas Law*, 32 INST. ON OIL & GAS L. & TAX'N 117, 146-47 (1981).

86. *Holmes v. Kewanee Oil Co.*, 233 Kan. 544, 664 P.2d 1335 (1983) (current market value), *cert. denied*, 106 S.Ct. 322 (1985). In *Gilmore v. Superior Oil Company*, 192 Kan. 388, 388 P.2d 602 (1964), the Kansas Supreme Court, without comment, quotes the following passage from Merrill on COVENANTS IMPLIED IN OIL AND GAS LEASES:

'If it is the lessee's obligation to market the product, it seems necessarily to follow that his is the task also to prepare it for market, if it is unmerchantable in its natural form. No part of the costs of marketing or of preparation for sale is chargeable to the lessor.'

*Gilmore*, 192 Kan. at 393, 388 P.2d at 607 (quoting M. MERRILL, *supra* note 1, at 214). Interpreting the royalty clause, the court held the lessee cannot charge the lessor with a proportionate share of compression costs incurred to sell the gas to a pipeline.

## B. *Conflict With Public Interests*

Courts generally serve a "referee" function when interpreting oil and gas leases. They attempt to settle the dispute by determining, and sometimes balancing, the respective rights of the lessor and lessee. Often this referee process adversely affects unrepresented parties—like the public. If the "public interest" does not happen to coincide with the interests of either the lessor or lessee, chances are the matter will be resolved without addressing relevant policy considerations. In the few cases where courts have openly addressed affected public interests, promoting such interests also tended to promote the interests of one of the parties to the dispute.<sup>87</sup>

Because the parties have chosen to express their relationship using an open-ended agreement, thereby electing to rely upon judicial action to fully define their rights, it would seem appropriate for courts to define the relationship so as to promote recognized public policies. This is especially appropriate when the relationship concerns a natural resource.<sup>88</sup> If courts are going to come to the aid of lessors in interpreting the oil and gas lease, they should inquire whether the interpretation will affect public interests in the resource.<sup>89</sup>

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87. In *Superior Oil Co. v. Devon Corp.*, 604 F.2d 1063 (8th Cir. 1979) the court referred to national energy policy as a basis for implying a covenant to conduct further development:

[A]t this particular point in time the public interest in encouraging the prudent development of oil and gas leases is particularly important. The development of domestic sources of oil will reduce the amount of oil which has to be imported and will thereby redound to the national interest by helping to reduce the deficit trade balance and to render the nation less susceptible to economic dislocations arising from political disturbances in foreign oil producing nations.

*Id.* at 1069. Cf. *Classen v. Federal Land Bank of Wichita*, 228 Kan. 426, 435, 617 P.2d 1255, 1262 (1980) (conservation policy considered in interpreting habendum clause of defeasible term mineral interest).

88.

When parties write an open-end contract like an oil and gas lease, they commit to the courts in advance the resolution of conflicts they cannot presently resolve. It does no violence [sic] to this incomplete bargain that public policy should weigh in the decisional process; and when the subject matter of the open-end contract is a natural resource as vital as oil and gas, the public interest dictates that it should.

5 H. WILLIAMS & C. MEYERS, *OIL AND GAS LAW* § 802.2, at 13 (1985).

89. In the area of implied covenants, commentators disagree whether courts should attempt to promote a "public policy" when defining the scope of each party's rights and obligations under the oil and gas lease.

Compare Martin, *A Modern Look at Implied Covenants to Explore, Develop, And Market Under Mineral Leases*, 27 INST. ON OIL & GAS L. & TAX'N 177, 212 (1976) and Pierce, *supra* note 5, with Weaver, *Implied Covenants in Oil and Gas Law Under Federal Energy Price Regulation*, 34 VAND. L. REV. 1473, 1492 (1981) and Williams, *Implied Covenants in Oil and Gas Leases: Some General Principles*, 29 U. KAN. L. REV. 153, 172 (1981).

Because the contract concerns important finite natural resources, courts should favor an interpretation which will protect and conserve the resource. It would seem reasonable for courts to

What are the "affected public interests"? Conservation of energy resources has been, and continues to be, a major public concern.<sup>90</sup> During the past decade, the focus has been on "use" conservation.<sup>91</sup> However, "production" conservation has been a major focus since the early 1900s.<sup>92</sup> The goal of production conservation is to obtain the maximum recovery of the resource economically possible.<sup>93</sup> The standard relationship often prevents a lessee from attaining maximum resource recovery. Absent direct conflict with statutory conservation laws, courts have generally refused to promote an oil and gas conservation ethic.<sup>94</sup>

Perhaps judges feel conservation interests will be protected at the administrative level by the state oil and gas conservation commission. However, like the courts, conservation commissions have assumed the role of "referee."<sup>95</sup> Typically, the only parties actively participating at the conservation commission level are lessors and lessees. The public

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consider, in determining how to interpret the contract, the effect such interpretation may have on public interests in the resource. Parties to the contract should not expect courts to maximize their rights at the expense of public interests. If the parties want to control the interjection of public policy, they can write a more complete contract which specifically addresses the uncertainties now commonly found in the oil and gas lease.

RESTATEMENT (SECOND) OF CONTRACTS § 207 (1981) provides: "In choosing among the reasonable meanings of a promise or agreement or a term thereof, a meaning that serves the public interest is generally preferred." This appears to be a fairly uncharted area of contract law. Comment a to Section 207 limits the scope of its effect to "agreements which affect a public interest." Any agreement which concerns the development of oil and gas arguably affects a public interest. The public interest has been specifically recognized in cases upholding governmental authority to restrict private uses of property to protect and conserve the oil and gas resource. *Burford v. Sun Oil Co.*, 319 U.S. 315, 324 (1943) (relying upon waste prevention); *Henderson Co. v. Thompson*, 300 U.S. 258, 267 (1937) (relying upon waste prevention). See *Pierce*, *supra* note 5, at 58-61.

90. Although the concern is always present, it usually manifests itself when the price of oil exceeds \$35 a barrel. Oil and gas industry leaders today are expressing concern over what appears to be the makings for a repeat performance of the "energy crisis." See generally *OIL & GAS J.*, Dec. 1, 1986, at 17. America's fickle energy policy during the past decade suggests government will continue to deal with long-term problems on a short-term basis. Crisis becomes the essential ingredient of the policy.

91. "Use conservation includes any process or activity designed to reduce total energy consumption. The end result is a savings of energy already produced and available for use." *Pierce*, *supra* note 5, at 3.

92. "[P]roduction' conservation relieves scarcity by increasing the total supply of energy. Production conservation uses existing geophysical knowledge and technology to develop oil and gas reservoirs to achieve maximum recovery of the resource. Production conservation can result in new oil and gas supplies not otherwise available for use, and use conservation." *Pierce*, *supra* note 5, at 3.

93. *R. SULLIVAN*, *supra* note 42, at § 135.

94. See, e.g., *Dobson v. Arkansas Oil & Gas Comm'n*, 218 Ark. 160, 235 S.W.2d 33 (1950); *Western Gulf Oil Co. v. Superior Oil Co.*, 92 Cal.App.2d 299, 206 P.2d 944 (1949). Where secondary recovery is involved, some courts have tended to be somewhat more conservation-conscious in their decisions. See *Jameson v. Ethyl Corp.*, 271 Ark. 621, 609 S.W.2d 346 (1980); *Baumgartner v. Gulf Oil Corp.*, 184 Neb. 384, 168 N.W.2d 510 (1969), *cert. denied*, 397 U.S. 913 (1970).

95. For example, the Utah conservation commission is required in effect, to arbitrate lessor/lessee disputes concerning lessor's share of production. UTAH CODE ANN. § 40-6-9 (Supp. 1986).

interest is theoretically represented by the commission's staff, but they rarely inject new issues into the foray unless it is clearly mandated by statute or raised by one of the parties. It is odd that public interest groups never get involved with vital energy decisions made by conservation commissions. Instead, they focus their efforts at the public utility commission where the energy is being purchased, distributed, or converted to another form of energy and then distributed.<sup>96</sup> There would seem to be a tremendous untapped potential for public interest group intervention at the conservation commission level. In most cases, this would appear to be beneficial to the lessee because it is usually the lessee's interest, and not that of the lessor, which coincides with public interests in the resource.<sup>97</sup>

If a statutory conservation mandate clearly conflicts with the standard relationship, the standard relationship must yield.<sup>98</sup> However, conservation laws do not prohibit waste—they merely regulate waste.<sup>99</sup> "Modern" conservation laws are the product of compromises between large and small developers and between developers and royalty owners.<sup>100</sup> The energy-buying public has not become involved. When they do, perhaps the full potential of production conservation will finally be

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96. By focusing attention and political accountability at the public utility level, long-term conservation goals may be sacrificed for the short-term goal of lower gas or electric rates. This may be a particular danger in states which combine public utility and conservation authority in a single regulatory body. If the only issue that the public focuses on is the ultimate retail cost of energy, the regulatory authority will, and probably should, make such concerns its major focus. *See generally* Pierce, *supra* note 5, at 77-78.

97. In many situations the public's interest will not necessarily coincide with the developer's immediate needs. For example, if the public were actively involved, commission approval of gas venting and flaring would probably be granted in fewer cases.

98. Compare *U.V. Industries, Inc. v. Danielson*, 184 Mont. 203, 602 P.2d 571 (1979) with *Rush v. King Oil Co.*, 220 Kan. 616, 556 P.2d 431 (1976) and *Renner v. Monsanto Chem. Co.*, 187 Kan. 158, 354 P.2d 326 (1960).

99. No state legislature has taken action to effectively limit the rule of capture to promote maximum production conservation. State spacing, market demand, and proration laws merely attempt to achieve a minimum level of production conservation while retaining the basic capture framework. Unitization statutes could be used to maximize production conservation. However, most states having such statutes require the consent of an unrealistic percentage of working and non-working interest owners before a reservoir can be unitized. Although significant conservation benefits could be derived from unit operation, most reservoirs will be developed under the rule of capture because of inadequate state laws.

Pierce, *supra* note 5, at 5 (footnotes omitted).

100. The public seldom gets involved even when conservation laws are being enacted. Usually the process consists of the conservation commission coordinating the competing desires of large developers and small developers. Next, the commission makes adjustments to incorporate the demands of royalty and other nonoperating interest owners. The final stage is to incorporate the commission's regulatory goals and try to come up with a final proposal which all the actively participating parties can support.

realized.<sup>101</sup>

Most of the issues arising under the oil and gas lease will not "conflict" with established conservation laws. However, resolution of such issues often impacts conservation of the resource. The standard relationship which courts have fashioned from the oil and gas lease often requires the lessee to act in a manner detrimental to public interests in the oil and gas resource. To evaluate the extent to which the standard relationship impacts public interests, the interpretive process, as applied to express and implied lease terms, is examined.

An express term which has been the subject of extensive judicial attention is the habendum clause requirement of "production."<sup>102</sup> Most courts interpret this term to require production in "paying quantities."<sup>103</sup> The court's goal is to protect the lessor's interest by terminating the lease when production is not sufficient to cover operating expenses. This prevents the lessee from maintaining the lease for speculation.<sup>104</sup> Interpretation of "production" has been resolved through the court's referee function. The word "production" is unclear so it is interpreted against the lessee to protect the interests of the lessor. Does this interpretation comport with the public interest in resource conservation? In at least one respect, the interpretation is in accord with public policy to encourage development. If the lease terminates when operations become unprofitable, it might encourage further exploration and development of the lease in an effort to discover new production to keep the lease alive.

However, the paying quantities requirement often causes a loss of otherwise recoverable reserves. If lessees are able to maintain leases with something less than paying quantities, they will be more inclined to continue producing from the reservoir even though they incur a net operat-

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101. If the price of oil and gas had remained at 1979-80 levels, and if the prospect of shortages had continued, conservation regulation would most likely have been restructured to reflect the desires of the general public versus those of developers and landowners.

102. The typical habendum clause provides for a definite term which may be extended for an indefinite period of time while production is obtained from the leased acreage. The definite term is called the "primary term" and the indefinite extension of the lease by production is called the "secondary term." To extend the lease into the secondary term, one of the substances described in the habendum clause must be produced from the leased land. If, at the end of the primary term, there is no production, or some contractual excuse or substitute for production, the lease terminates. *Compare* Elliott v. Crystal Springs Oil Co., 106 Kan. 248, 187 P. 692 (1920) ("production" requires actual sale of product) with *McVicker v. Horn*, 322 P.2d 410 (Okla. 1958) (discovery of oil or gas satisfies production requirement for a reasonable time).

103. *Clifton v. Koontz*, 160 Tex. 82, 325 S.W.2d 684, 690 (1959)(citing *Garcia v. King*, 139 Tex. 578, \_\_\_, 164 S.W.2d 509, 511 (1942)). Apparently, West Virginia and Kentucky have a less rigorous production requirement. OIL AND GAS LAW, *supra* note 6, at 205-06.

104. *E.g.*, *Garcia v. King*, 139 Tex. 578, 164 S.W.2d 509 (1942).



ing loss. The incentive to continue non-paying production would be the speculative value of the lease, the potential for discovering new production at new locations and depths, or the possibility of an increase in oil and gas prices. The net result is recovery of oil and gas which would otherwise be left in the reservoir and, in many cases, would be unrecoverable.

Another benefit of a "production" rule would be to avoid litigation on the difficult task of determining what is "production in paying quantities." Litigation on this issue will most likely increase in light of recent dramatic decreases in oil and gas prices.<sup>105</sup>

To put the problem in perspective, consider the following:

Landowner, *A*, leases to developer, *B*. The lease is to continue so long as oil or gas is produced from the leased land, Section 30. *B*, within the primary term of the lease, drills a producing oil well. At this time the price of oil is \$30 per barrel. *B* finds it profitable to drill three more wells on the leased land. After many years of production, the four wells are each producing two barrels of oil per day. At \$30 a barrel for oil, the operation is profitable.

Due to factors beyond *B*'s control, and generally beyond the control of the United States, the price of oil falls to \$15 a barrel and the operation becomes unprofitable. Depending upon the accounting period selected by the court to examine income and expenses, the lease may have terminated for failure to produce in paying quantities.

If the lease is terminated, *B* will probably plug and abandon the wells and *A* will be free to develop the land or lease it to another developer, or to *B*. Although *A* may be able to lease the land, it is doubtful it will be developed until the price of oil increases—the same event which would make *B*'s operations profitable.

The price to society, in allowing *A* to try to obtain a new lease bonus, will often be a permanent loss of production attributable to *B*'s operations. *B* may have been willing to continue the lease in effect, producing eight barrels of oil each day, hoping for an upswing in the price of oil or a new discovery in the immediate area. Perhaps with an increase in oil prices an enhanced recovery project would be feasible. Although the interpretation requiring production in paying quantities may be a fair resolution as between the lessor and lessee, public interests can be adversely affected.

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105. As production becomes marginal, distinguishing between paying and nonpaying operations becomes more difficult. Many basic issues in this area remain unresolved. For example, what period of time should be considered to determine whether income sufficiently exceeds expenses? See D. PIERCE, *supra* note 11, § 9.24.

Courts unwilling to consider public interests when applying the interpretive process to express terms should not feel so constrained when entering into the realm of implied terms. In pursuit of the parties' respective goals under the oil and gas lease, courts have imposed a number of implied obligations, called "implied covenants," on the lessee.<sup>106</sup> The primary function of implied covenants is to ensure that the lessee diligently and competently pursues development of the lease, produces and markets what is found, and protects the lease from operations on adjacent properties.<sup>107</sup> The interest which courts identify for protection is the lessor's expectation of royalty.<sup>108</sup> This is coupled with a general abhorrence for lessees who hold leases for "speculation" instead of current development.<sup>109</sup> Public interests often suffer in the process of protecting the lessor's interests.

Consider in this regard the implied covenant of further development. The development covenant requires the lessee to drill additional wells on the lease when such development would be undertaken by a "prudent operator."<sup>110</sup> When applying the prudent operator standard to the development covenant, the traditional inquiry has been: 1. Can another well be legally drilled on the lease? 2. Is it likely to produce enough oil or gas to recover the costs of drilling, completing, and operating the well plus pay a reasonable profit to the lessee? If so, the lessee must drill or lose the undeveloped portion of the lease.<sup>111</sup> The effect of the covenant is to encourage development, thereby maximizing the lessor's royalty interest.<sup>112</sup>

In an effort to zealously protect the lessor's royalty interest, courts typically impose requirements on lessees which appear contrary to the public's interests in the oil and gas resource. Consider the following:

Landowner, *A*, leases Section 30 to developer, *B*. *B* drills a producing gas well on Section 30. *B* is able to demonstrate that one well will eventually drain all the gas beneath Section 30 and that there is no danger of drainage to wells located on adjacent lands. The well is in an

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106. M. MERRILL, *supra* note 1, at § 3.

107. *Id.* § 4.

108. *E.g.*, Renner v. Monsanto Chem. Co., 187 Kan. 158, 167, 354 P.2d 326, 333 (1960).

109. *E.g.*, Sauder v. Mid-Continent Petroleum Corp., 292 U.S. 272, 281 (1934); Meaher v. Getty Oil Co., 450 So.2d 443 (Ala. 1984); North York Land Assoc. v. Byron Oil Indus., 695 P.2d 1188 (Colo. Ct. App. 1984).

110. R. HEMINGWAY, *supra* note 68, at § 8.3(A).

111. *See generally id.* § 8.11.

112. "In evolving the doctrine of implied covenants courts have placed great emphasis on individual property rights and construed oil and gas leases 'to promote development and prevent delay' upon the theory that the lessor had the right to have his land developed as rapidly as possible." Renner v. Monsanto Chem. Co., 187 Kan. 158, 167, 354 P.2d 326, 333 (1960) (citations omitted).

unprorated field; a second well could be drilled on the lease without violating conservation laws.

*A* demands a second well on the lease asserting that it is required under the implied covenant of further development. If *A* can demonstrate *B* is likely to recover the costs of drilling, completing, and operating the second well, plus a reasonable profit, then *B* will be required to drill the second well.<sup>113</sup>

Because the lessor does not share in the costs of development, any increase in production will currently benefit the lessor's interests. When the price of oil and gas fall, the situation may become further aggravated. A fall in price will mean a reduction in the value of lessor's royalty. When this occurs, the lessor may demand further development to maintain the level of the previous royalty income. This occurs at a time when, due to falling prices, the lessee will be unwilling to conduct further development of the lease. Under the standard relationship, the extent and rate of development will be determined by applying the prudent operator standard. Courts, to ensure protection of lessor's royalty interest, generally require additional development whenever it is consistent with state and federal law and likely to be "profitable" for lessee. Courts tend to place primary emphasis on profitability without considering other significant factors, for example:

1. What effect will additional development have on total recovery from the reservoir?
2. Is this the best time to bring in additional production?
3. Although profitable, what will further development do to lessee's overall cost of producing from this lease?<sup>114</sup>

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113. Even if the well was in a prorated field, and *B* is producing its full allowable, the development covenant may require additional wells on Section 30. Assume the allowable is determined by multiplying the number of acres attributable to the well by the open flow capacity of the well. Conservation laws do not prohibit the drilling of an additional well on Section 30, but the acreage factor for all wells on a section of land cannot exceed 640 acres. Therefore, *B* can drill a second well on Section 30, but the net effect will be to permit an increase in production only to the extent the open flow capacity of the new well exceeds the open flow capacity of the existing well. This amount will be further reduced because presumably only 320 acres will be attributable to the new well having the greater open flow capacity. The allowable for the existing well would be reduced because its acreage factor would be cut from 640 to 320.

However, if the lessor can demonstrate the costs of the second well can be recovered from production, plus a reasonable profit for the lessee, the development covenant requires lessee to drill the second well. *Rush v. King Oil Co.*, 220 Kan. 616, 626-27, 556 P.2d 431, 440-41 (1976); *Renner v. Monsanto Chem. Co.*, 187 Kan. 158, 170-71, 354 P.2d 326, 335-36 (1960). Projected income from the well will be determined under the applicable conservation laws so the relevant production figures will be based upon prorated production, not open flow potential. See *Fischer v. Magnolia Petroleum Co.*, 156 Kan. 367, 375, 133 P.2d 95, 101 (1943), *followed*, 156 Kan. 722, 137 P.2d 139 (1943).

114. Although it may be profitable under current oil and gas prices to drill a second, third, or tenth well on the lease, such action could cause premature abandonment of the lease at later stages of lease operation. Drilling multiple wells will affect drainage patterns as well as lessee's operating cost

4. Could the money necessary to drill the well be better spent somewhere else?<sup>115</sup>

Drilling two wells on the section may also set off a chain reaction under the implied covenant to protect against drainage.<sup>116</sup> When *B* alters the development pattern on Section 30, adjacent lessees will presumably have to respond by drilling additional wells, if profitable, to protect their leases against drainage.<sup>117</sup> The irony is that many times, to be a "prudent operator" under the standard relationship, a developer must take action which is, as a matter of petroleum geology, engineering, and economics, imprudent.<sup>118</sup>

Another consideration is the proliferation of litigation which implied covenants have caused. The determination is highly fact-sensitive; a judgment is often the first legal indication that the covenant has been breached.<sup>119</sup> Waste of the resource may occur as a charge against society so that the lessor can receive additional royalty income. The charge against the lessee is the expenditure of expertise and money to drill a well technically unnecessary to recover the resource. Had the lessee not been required to drill the well on Section 30, the lessee might have been able to conduct operations somewhere else and make new reserves available to the public.

The oil and gas lease, and the standard relationship it has created, places the parties to the relationship at odds with one another. Not only

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structure for the lease. The lease will reach the point of marginal return sooner because the lessee will have to operate, for example, two wells to get four barrels per day of oil from the lease. If only one well had been drilled, and the drainage pattern not disrupted by a second well, perhaps the lessee could have recovered something in excess of two barrels per day. This would make the lessee's operation more efficient, thereby delaying abandonment and what, in most cases, will be a permanent loss of oil.

115. The money used to drill additional wells merely to maximize the present value of lessor's royalty could be used to explore for new reserves or develop known reserves which cannot be produced from existing wells.

116. When the lessee responds to the the lessor's demand for further development and drills the required well(s), the well density on the lease will be altered and may promote drainage toward lessor's land from adjacent lands. This is permissible under the rule of capture and highly desirable for the lessor. Depending upon the cost to drill the additional well and lessee's ownership interest in surrounding acreage, the lessee may or may not benefit. Because conservation regulation merely establishes ground rules for playing the capture game, the lessor will use the implied covenants to ensure lessee maximizes lessor's position under the rule of capture.

117. *R. HEMINGWAY, supra* note 68, at § 8.5. Where the lessee owns adjacent acreage, creating a "common lessee" situation, the profitability requirement may be eliminated or modified. *See generally id.* § 8.7.

118. *Pierce, supra* note 5, at 36.

119. Presenting the facts often requires extensive economic and technical evidence. *See Corr v. Continental Oil Co.*, 145 Kan. 78, 84, 64 P.2d 30, 33 (1937), *adhered to*, 147 Kan. 1, 75 P.2d 212 (1938).

do their individual interests conflict, judicial attempts to balance their interests often place the relationship at odds with significant public interests. The process of resolving disputes under the relationship often requires courts to make complex and difficult factual determinations. The net result is parties to the relationship must resort to time-consuming and resource-wasteful litigation to conduct their enterprise. In the process, the public's natural resources and the lessee's economic resources are wasted.

Drafting a better charter for the relationship will certainly help matters. Many issues requiring court intervention can be eliminated through careful drafting. This may, or should, require a departure from the traditional form of oil and gas lease. However, many of the issues giving rise to disputes and development contrary to public interests are traced to the nature of the relationship. Drafting new forms of leases which retain the basic relationship will not address the inherent problems of the standard lease. To address these problems, a new relationship must be created which eliminates, reduces, or is able to manage conflicts associated with the standard relationship.

#### IV. ALTERNATIVE RELATIONSHIPS

The basic flaw associated with the standard relationship appears to be the divergent goals and economic interests of the parties to the relationship. The lessee wants to hold the leased land with minimal development obligations and conduct further development only when necessary to maximize investment return. The lessor wants immediate and maximum development to generate cost-free royalty income. The solution to the problems caused by the standard relationship is to find a workable development arrangement where the goals and economic interests of the landowner and developer tend to coincide. Because the basic goal of the parties engaging in oil and gas development is to make money, we can focus upon relationships which bring their economic interests in harmony.<sup>120</sup> Disputes, and litigation, will undoubtedly continue as both parties try to maximize their position under alternative relationships. However, many opportunities for dispute can be avoided by, to the extent feasible, eliminating incentives to assert positions which are counter to the interests of other parties to the relationship.

To harmonize the economic interests of the landowner and devel-

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120. The lessor who owns the surface estate will, of course, be concerned about the effect of lessee's operations on the surface estate.

oper, the relationship must place the landowner in an at-risk position so that the landowner's return on development will, in some manner, be tied with the costs of development.<sup>121</sup> This seems to be the essential ingredient for creating an alternative relationship. Certainly, other adjustments will be required. For example, the developer must change traditional lessee attitudes toward landowner participation in the development process. The landowner will have new concerns in the negotiation process regarding matters such as liability for development costs or accidents. These problems, and solutions, will evolve as experience with the new relationship grows.

Relationships already used in the oil and gas industry suggest possible alternative approaches for obtaining development rights from a landowner. These include various forms and degrees of joint operation. Before considering these, however, an alternative relationship, now commonly used in securing rights to mine coal, is examined—developer ownership of the mineral rights.<sup>122</sup>

#### A. *Purchase Mineral Rights*

Purchasing the minerals for the development of oil and gas would defeat one of the lessee's primary goals in the development process: to obtain the right to develop for a sum substantially less than the rental or market value of the land. The developer might try to avoid paying full price for the minerals, while obtaining the development rights, through the purchase of a defeasible term mineral interest.<sup>123</sup> If the landowner is willing to give such an interest, the developer may be able to eliminate delay rental and many implied covenant problems. The only opportunity for dispute would be whether the requisite "production" necessary to

121. Because the landowner will share more of the risk of development, the potential return on the investment should be commensurate with the increased risk.

122. Some coal developers now purchase the mineral and surface estates. This avoids many surface use and subjacent support problems associated with surface and subsurface coal mining. However, the coal developer, through exploratory drilling, usually enters negotiations with reliable data concerning the potential value of the land for coal mining purposes. Typically, this will not be the case with oil and gas.

123. The mineral estate, as with other interests in land, can be limited to a specified time or until a specified event occurs. The most common limitation requires production of oil or gas in paying quantities after a specified period of time. For example, *A* could grant *B* all the oil and gas in Section 30 for "three years and so long as oil or gas is produced from Section 30." Such a grant creates a fee simple determinable, generically referred to as a defeasible fee, with title vesting immediately in grantee subject to grantor's possibility of reverter in the event production of the stated substances fails to continue. The three years is the fixed "term;" the grant is "defeasible" because it will terminate after the three year term if the production contingency does not occur. Therefore, the interest is sometimes called a "defeasible term mineral interest." See generally *Wilson v. Holm*, 164 Kan. 229, 234-35, 188 P.2d 899, 904 (1948); *Richards v. Shearer*, 145 Kan. 88, 91-92, 64 P.2d 56, 59 (1937).

keep the term interest from reverting to the landowner exists.<sup>124</sup>

Because the only consideration received by the landowner will be the initial purchase price, the cost of acquiring development rights will probably be considerably more than a lease bonus and delay rental. The focus of future disputes would probably change to surface use issues because the landowner would not be receiving any periodic income associated with development.<sup>125</sup> The resourceful developer may try to acquire the defeasible term mineral interest by providing for a periodic payment to the landowner based upon production. However, this alternative would seem to retain all the conflicts associated with the oil and gas lease and invite courts to transfer oil and gas lease jurisprudence to the defeasible term mineral interest. Courts have already done this in many situations.<sup>126</sup>

Unless developers are willing to pay the additional up-front consideration for a mineral interest or defeasible term mineral interest, purchasing the minerals will not be a viable alternative relationship. Landowners are less likely to sell minerals in their land and will probably opt for a less permanent arrangement. A sale of minerals also defeats one of the landowner's major goals—the ability to participate in any discoveries and the resulting windfall to the lessor. There is also much to be said for maintaining, with the landowner, an economic interest in the enterprise. Surface use disputes can be as time-consuming as implied covenant disputes.

Purchasing mineral interests may be a viable alternative for established oil and gas developers. Their participation in the industry is in the nature of a long-term investment. For the used car salesman and other minor participants in the industry, purchasing mineral rights will not be an alternative because of the additional up-front consideration required to acquire the interest. Even with the major industry participants, mineral interest purchases will provide an alternative only when landowners

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124. "Production" to maintain the defeasible term mineral interest must be in "paying quantities." Most courts have looked to interpretations under the oil and gas lease habendum clause to resolve defeasible term mineral interest production issues. *E.g.*, *Texaco, Inc. v. Fox*, 228 Kan. 589, 592, 618 P.2d 844, 847 (1980). However, oil and gas lease jurisprudence has not been fully accepted. *Compare* *Classen v. Federal Land Bank*, 228 Kan. 426, 617 P.2d 1255 (1980) (defeasible term mineral interest) *with* *Somers v. Harris Trust & Sav. Bank*, 1 Kan. App. 2d 397, 566 P.2d 775 (1977) (oil and gas lease).

125. There appears to be a direct correlation between the receipt of income from the enterprise and the landowner's tolerance for surface use intrusions. At least one court has recognized that a piece of the action fosters harmony and is a valuable asset of the lessee. *See* *Foertsch v. Schaus*, 477 N.E.2d 566, 571 (Ind. Ct. App. 1985).

126. *E.g.*, *Wilson v. Holm*, 164 Kan. 229, 188 P.2d 899 (1948).

are willing to part with their minerals at a price which the developer can afford, taking into consideration the speculative nature of the interest being purchased.<sup>127</sup>

### B. *Joint Operations*

To accomplish each party's goals, some form of joint operation appears in order. Several different types of arrangements would give the landowner an economic interest in the venture while ensuring that the landowner's interests tend to coincide with those of the developer. New goals of the parties will be: 1. Developer wants to retain primary responsibility for development decisions and operations. 2. Landowner wants to avoid personal liability for the costs and risks associated with development. These goals can be accomplished in varying degrees. Generally, placing more authority with developer to make development decisions will result in a corresponding reduction in the landowner's potential liability for costs and risks associated with development.

One form of development relationship which meets these goals is the net profits interest.<sup>128</sup> By compensating the landowner with a share of the developer's net profits, the landowner will be more inclined to support the developer's decisions on the rate and extent of development. The landowner will want immediate development to generate production. Any delay in immediate development should be expressly negotiated and provided for in the development contract. Presumably the developer will pay an up-front cash payment to delay development.<sup>129</sup> The landowner, after discovery, because his share of production is calculated on net profits instead of gross production, will be less likely to make development demands which may be marginally profitable to the developer.

The less it costs the developer to produce a barrel of oil or a cubic

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127. When the developer purchases the mineral interest, the risk previously shared with a lessor is assumed by the developer. This additional risk is calculated by subtracting from the amount paid to purchase the minerals the amount that would have been paid in bonus and delay rental if the property had been acquired by lease. However, the developer who purchases minerals will have a salvageable investment; the minerals may be retained, without development obligations, for future speculation. The developer's only obligation will be to pay taxes on the interest and file a periodic statement of claim if a dormant mineral act is in effect. This assumes that a perpetual interest, as opposed to a term or defeasible interest, has been taken in the minerals.

128. For purposes of this article, a net profits interest is defined as a share of the amount remaining from the sale of production after deducting the cost of drilling, completing, equipping, and operating wells on the designated land. Nothing is payable until the costs of initial development, plus current operating expenses, are recovered. *See generally* J. LOWE, *supra* note 13, at 40-41.

129. However, developers should be careful to avoid the administrative nightmare of delay rental obligations. *See* D. PIERCE, *supra* note 11, at § 11.20.



foot of gas from the land, the more the developer and the landowner will realize in net profits. If the landowner forces the developer to take action which results in a loss, the landowner will do so at the risk of losing the right to participate in production from the land. By way of example, consider the following:

Landowner, *A*, authorizes Developer, *B*, to develop Section 30 for oil and gas. *B* pays *A* a specified sum of money for the option to develop Section 30 during a three year period. Prior to the end of the three year term, *B* drills a producing gas well on Section 30. *B* is able to demonstrate one well will eventually drain all the gas beneath Section 30 and there is no danger of drainage to wells located on adjacent lands.

*A*, under his agreement with *B*, is entitled to 25% of *B*'s net profits derived from *B*'s Section 30 operations. It cost *B* \$250,000 to drill and complete the gas well. Payout will occur, depending upon gas prices, in approximately two years. At that time, *A*, assuming no serious operational problems, will begin to share in 25% of the amount remaining after selling production and paying production expenses.

If *A* wants another well on Section 30, *A* must be willing to forego net profits to the extent necessary to allow *B* to recover the cost of drilling, completing, and operating the well. Depending upon the terms of their agreement, *A* may also have to share in the risk of a dry hole by adding dry hole costs to the total amount *B* must recover from Section 30 production before net profits are generated.

When the well becomes marginal, *B* will continue to operate the lease until it becomes unprofitable. However, unprofitable operation under a net profits interest will occur at a later point in time than with the oil and gas lease. Under a net profits arrangement, *B* will continue to operate the well so long as 100% of the value of production sales exceeds production costs. Under the oil and gas lease, assuming the lessor has a 1/8th royalty interest, the lessee will continue to operate the well so long as 87.5% of the value of production sales exceeds production costs. To the extent the net profits interest encourages greater recovery from the reservoir, the public interest in resource conservation is served.

When the price of oil and gas drops, *A* may be willing to curtail or cease operations until higher prices, and a better profit margin, are available. Although the royalty owner could make this same concession, the net profits interest owner may be more willing because his income may be reduced more severely during a downward price shift.

To make such a relationship workable, the agreement between the developer and the landowner must clearly define the expenses which can

be deducted in determining net profit.<sup>130</sup> The developer must also be given primary authority to make development decisions.<sup>131</sup> For example, *B* may want to spend money to rework the well because *B* feels it is necessary to maintain or improve production. Although *B* must pay for the reworking operation, *A* may object because it would interfere with the current flow of income from the well. *A* may also be less willing to undertake improvements which will not increase the flow of income from the well. For example, higher cost operating techniques may be required to avoid environmental problems. Developers have become accustomed to internalizing environmental costs as a cost of doing business. Although landowners may have, on prior occasions, called for a cleaner environment, they may not be so adamant once they have the opportunity to directly pay for it out of their net profits.

If the developer has the sole authority to make development decisions, the agreement, and presumably the courts if the agreement is silent on the matter, should require the developer to act as a "prudent operator."<sup>132</sup> The prudent operator in this situation is not the same as the prudent operator standard used in implied covenant matters. The implied covenant prudent operator must act in a manner consistent with the often conflicting interests of the lessor and lessee. Under the net profits situation, all that need be asked is whether a competent operator would have taken certain action to maximize the profits from the well or Section 30. This type of standard is much easier to apply because it does not attempt to balance competing interests in defining prudent conduct. Competent developers will not knowingly take risks or act, or fail to act, when there is no reasonable basis to believe it will result in greater long-term or short-term profits.

The agreement should clearly define the time when the relationship will terminate.<sup>133</sup> One possibility is to begin by identifying the specific expenses which will be subtracted from current production income to

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130. Professor Lowe states in his treatise:

The methodology for determining when a net profit has been made is crucial when net profits interests are created. Sometimes "net profits" will be defined so that costs of exploration, drilling and completing are taken into account, as well as operating costs. Or, only operating expenses may be considered. Whatever the meaning intended by the parties, it is important that they define net profits carefully and completely, because reference to a "net profits interest" in and of itself is ambiguous.

J. LOWE, *supra* note 13, at 41. See *Kumberg v. Kumberg*, 232 Kan. 692, 659 P.2d 823 (1983) (problems determining how to calculate "net profit").

131. See generally *Garfield v. True Oil Co.*, 667 F.2d 942 (10th Cir. 1982).

132. *Id.* See also 5 E. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 63.5 (1978).

133. The parties should also address whether the developer can unilaterally terminate the agreement prior to the agreed upon terminating event. Cf. *Noel v. Locker*, 382 P.2d 734 (Okla. 1963).

determine the economic status of current operations. Many expenses included to determine net profits will be excluded in defining the time when the agreement will terminate. For termination purposes, only the current "ordinary" operating expenses should be considered. "Ordinary" operating expenses for this purpose should be defined to include pumping costs, while excluding major expenses like reworking operations, equipment replacement, plugging costs, and the cost of enhanced recovery investments.<sup>134</sup> After the "ordinary" expenses have been defined, the agreement should provide for termination once production from the affected land fails to generate sufficient income to cover ordinary expenses over an agreed upon accounting period.<sup>135</sup> The developer may want to provide for an extended accounting period when enhanced recovery operations have been undertaken because this may require a longer period of time before production increases will be realized.

The developer must be willing to treat the landowner as an active participant in the venture. The developer must inform the landowner, before the fact, of development decisions which will impact on the cost of development.<sup>136</sup>

Other forms of joint operation suggest possible alternative relationships. The landowner may be willing to permit development in return for some form of carried working interest.<sup>137</sup> This would allow the landowner to participate in lease development without contributing capital to the venture. After initial development, if the landowner wanted to participate as a working interest owner, the landowner could so elect and contribute a proportional share of subsequent development costs. Following the pattern of the traditional farmout arrangement,<sup>138</sup> the land-

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134. The problem is similar to defining expenses to determine "paying quantities" under the oil and gas lease habendum clause.

135. Defining the accounting period would eliminate a major area of dispute encountered under the oil and gas lease determination of "paying quantities."

136. Lessees have been doing this for years with their covenants under joint operating agreements.

137.

A carried interest is a fractional interest, usually created from an oil and gas lease, free of some or all costs. Often, the interest is carried "to the casing point," the point at which the well has been drilled to the desired depth and a decision must be made whether or not to place production pipe, called casing, in the hole and proceed to complete the well for production. If so, it is free only of the costs of drilling and testing preparatory to completion. It is still liable for its share of the costs of completing, equipping and producing the well. In such a case, the carried interest is very much like a working interest except that it is free of the costs of drilling.

J. LOWE, *supra* note 13, at 41-42. See generally D. PIERCE, *supra* note 11, § 4.09.

138. If the lessee has acreage to be developed, but is currently unable or unwilling to conduct development operations, the acreage may be farmed out to another developer. The lessee (farmor) might assign the acreage to the person willing to develop (farmee), retaining an overriding royalty

owner could retain a royalty interest during the initial development and then have the opportunity to convert it to a working interest upon payout of the initial well.<sup>139</sup> All of these arrangements would require a carefully drafted operating agreement.<sup>140</sup> Available standard form operating agreements may not be workable when one of the joint interest owners is not familiar with the oil and gas industry.<sup>141</sup>

The alternative relationships mentioned in this section are used merely for demonstration. The only limitation on developers in devising an alternative relationship is the imagination of counsel. Counsel must refrain from having their thought processes channeled by the oil and gas lease. Instead, they should study the lessons which the oil and gas lease, and the resulting standard relationship, have to offer. After considering the weaknesses of the standard relationship, new relationships should be devised which avoid unnecessary conflict between the parties to the relationship while permitting development on terms acceptable to all affected parties.

When evaluating alternative relationships, counsel for landowners and developers should consider the effect existing law, designed around the oil and gas lease, will have upon the new relationship. For example, tax laws, lien laws, and statutory and common law affecting the development process must be considered to determine what effect, if any, it will have on the development relationship.<sup>142</sup> These collateral considerations, as with any other activity, will help shape the documents used to express the new relationship.

## V. CONCLUSION

The oil and gas lease has endured because courts have been willing to take an active role in "interpreting" the lease in accordance with what

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which is convertible to a working interest upon "payout" of the well. D. PIERCE, *supra* note 11, § 4.09.

139. The conversion from a royalty to working interest upon payout should be automatic and mandatory to ensure their economic interests, as to future development, will coincide.

140. Whenever the landowner has an opportunity to acquire a right to participate in the actual development of the property, the respective rights of the parties in conducting development must be specified by agreement.

141. The standard forms of joint operating agreement and accounting provisions may not be suited to the landowner/developer relationship. Typically, the landowner will play a much more passive role in development of the property than the typical lessee joint operator. The landowner will also want additional protection concerning liability for development costs and accidents. An inadequate operating agreement may rob the developer of any advantages the new relationship has gained.

142. See generally *Garfield v. True Oil Co.*, 667 F.2d 942 (10th Cir. 1982).

has become a standard relationship. The standard relationship has endured because lessees, and their attorneys, are generally unwilling to break with tradition and explore alternative relationships. This would be understandable if the present relationship were the optimum relationship.

However, the price paid by lessors, lessees, and the public, to operate under the standard relationship, is high. Litigation, a common adjunct to relationships replete with inherent conflicts, exacts a toll on the lessor, the lessee, and society. Expertise and money, which could otherwise be used for resource development, are channeled into litigation to try to bring harmony to a relationship structured to generate disharmony. The lessee, in order to be a "prudent operator" under the relationship, is often required to take what would otherwise be considered imprudent action.

Public interests often suffer under the standard relationship. Maximum recovery of the resource is prevented by the interpretation of express and implied lease terms in accordance with the standard relationship. Although the oil and gas lease could be interpreted in harmony with public interests, courts focus upon the interests of the lessor without addressing the effect such interpretation may have on public concerns. Courts could, without contorting the interpretive process further, consider established public concerns, like production conservation, when defining the standard relationship.

In searching for a better relationship to facilitate oil and gas development, the goal should be to structure the transaction to eliminate lessor/lessee conflicts inherent in the standard relationship. Eliminating the landowner altogether, through purchase of the mineral rights by the developer, is one solution. However, most developers will require an alternative which avoids large up-front payments to the landowner. Varying degrees of joint operation offer another alternative. If the landowner's economic interests in development and operation tend to coincide with those of the developer, major areas of potential dispute between the parties are eliminated. The goal of any form of joint operation, or any other alternative relationship, should be to condition the landowner's return from development upon the developer's success. If the developer drills a well which will not pay out for five years, the landowner's return should be tied to this contingency. Some form of sharing net profits is one way to accomplish this goal.

However, the goal of this article is not to identify the optimum rela-

tionship. All that can be done at this stage of the industry's experience is identify the oil and gas lease relationship as an unlikely candidate for the optimum relationship. This is an important step. Until the inherent problems associated with the standard relationship are recognized, attorneys will refrain from breaking with tradition and searching for alternatives.

The industry is again in transition; developers and their attorneys are looking for better, more cost-effective ways to conduct their business. This is the time to break with tradition and explore alternatives to the oil and gas lease. The optimum relationship will never be developed unless the industry is willing to experiment.

